HOUSE BUDGET COMMITTEE

Democratic Caucus

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SOCIAL SECURITY PRIVATIZATION AND THE BUDGET:

QUESTIONS AND ANSWERS

Prepared by the Democratic Staff of the House Budget Committee

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I. SOCIAL SECURITY AND THE BUDGET PROCESS

Q. Social Security is officially "off budget." What does that mean in practice?

Social Security Excluded From Presentations of Budget Totals. There are two ways that federal revenues, spending, and surpluses/deficits are commonly portrayed. The "on-budget" presentation excludes Social Security from total budget revenues, spending, and deficits/surpluses. The "unified budget" includes Social Security in the totals. The President's budget shows both the on-budget and unified budget totals. The Congressional budget resolution excludes Social Security revenues and outlays from total budget revenues, outlays, and deficits,[1] but it displays Social Security revenues and outlays separately. Social Security accounted for a nearly 30 percent of federal revenues and nearly one-quarter of federal spending in 2004, with revenues of $647 billion and benefit payments of $487 billion. Consequently, there is demand among policymakers for presentations of unified budget totals, because those totals summarize the government's overall impact on the economy, particularly in terms of the extent of government borrowing from the private sector. In addition, Social Security is currently running a surplus, so the unified budget deficit appears smaller than the on-budget deficit.

Social Security Excluded from Reconciliation.[2] There is a point of order in the Senate and House against a *reconciliation bill* if it contains provisions affecting Social Security. This point of order can be waived by a simple majority in the House and 60 votes in the Senate. In addition, the Congressional Budget Act's Byrd Rule imposes a 60-vote Senate point of order against *provisions* in reconciliation legislation that affect Social Security. The Byrd Rule can be used to strike specific provisions without bringing down the entire reconciliation bill. The 60-vote Senate points of order are significant because reconciliation bills are not subject to Senate filibuster.

Legislation Weakening Social Security's Financial Position Prohibited in House.[3] It is out of order in the House to consider legislation that would (a) worsen Social Security's cash-flow balance by more than $250 million over five years, or (b) reduce Social Security's 75-year actuarial balance by more than 0.02 percent of taxable payroll.[4] The point of order can be waived with a majority vote. The Rules Committee can also waive it.

Legislation Weakening Social Security's Financial Position Prohibited in Senate.[5] There are 60-vote Senate points of order against a budget resolution that decreases the Social Security surplus in any year covered by the resolution, and against legislation that reduces Social Security surpluses (or increases Social Security deficits) relative to the levels set forth in the budget

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[1] There are two exceptions to this rule, pertaining to income from taxation of Social Security benefits and Social Security administrative expenses.

[2] Congressional Budget Act, Sections 310 and 313.

[3] Tax legislation that indirectly affects revenue from Social Security benefit taxation is exempt.

[4] Budget Enforcement Act, Section 13302.

[5] See Footnote 3.

resolution for the first year, the first five years, or all years covered by the resolution.[6]

New General Fund Transfers to Social Security Prohibited. Section 710 of the Social Security Act prohibits any new provisions of law that provide for payments from the general fund to the Social Security trust fund, and vice versa, beyond the payments that were already authorized by law as of December 1985.[7] The scope of this provision is unclear. Congress has authorized two small new general fund payments to the trust fund since 1985.

[6]Congressional Budget Act, Sections 301(i) and 311(a)(3); H.Con.Res. 95 [2004 budget resolution] extended through 2008 the 60-vote requirement to override these points of order.

[7]Transfers authorized before December 1985 include proceeds from income taxation of Social Security benefits, deemed wage credits for military service, and other provisions.

II. BUDGETARY TREATMENT OF SOCIAL SECURITY PRIVATIZATION PLANS

Q. The Administration and some Congressional Republicans are talking about taking Social Security "off budget" to hide the real cost of privatization. Given that Social Security is already off-budget, what are Republicans proposing to do?

Some Administration officials and Republican lawmakers have suggested that budget documents should exclude the costs of Social Security privatization (that is, the cost of diverting part of the payroll tax away from the Social Security trust fund and into private accounts) from the calculation of the unified budget deficit and debt totals. Some have suggested leaving these costs out of the budget entirely. Others suggest portraying these costs in a special category to differentiate them from deficit spending. Social Security privatization would increase the publicly held debt (currently $4.3 trillion) by $1 trillion to $5 trillion over the next decade, depending on the plan. Some Republicans suggest assigning new labels to deficits and debt associated with Social Security privatization, calling them something like "transition investments," "recognition bonds," or "pre-paid benefits." These new measures would be displayed separately from the deficits and debt in Congressional and Administration budgets. Congress could include language in the privatization legislation instructing the Congressional Budget Office (CBO) to adopt the same presentation for purposes of estimating the deficit and debt effects of the legislation.

Another option floated recently would treat the account contributions as transfers from one government account to another. This approach would avoid a drastic increase in reported deficits and debt. It would also imply that the so-called "private" accounts are the property of the government rather than of individuals, which contradicts the White House's rationale for instituting private accounts in the first place.

Q. What happens if the President's budget and/or the Congressional budget resolution exclude Social Security privatization altogether?

The White House has indicated that it simply will exclude the costs of Social Security privatization from the budget altogether, rather than include them with a new label such as "pre-paid benefits." And some Republicans have argued that it does not make sense to consider long-range Social Security changes in the context of a traditional five- or ten-year budget resolution.

Excluding the costs of Social Security privatization from the President's and Congressional budgets would destroy these documents' usefulness for assessing the impact of federal policy on the economy, particularly the extent of the government's demand for credit. Over the last few years, the White House has taken to leaving the costs of certain policies — policies either promoted by or at least supported by the White House — out of the budget entirely. It has done so by using strategies such as omitting specific policies (such as the war in Iraq or the inevitable reform of the Alternative Minimum Tax), shortening the budget window to five years to hide the exploding costs of the President's tax cuts beyond that time frame, and relying on significant but unspecified "savings" to fund policy initiatives. Omitting a cost as large as Social Security privatization from the budget would render the budget meaningless as a statement of the government's fiscal policy. Such an omission would take the government further in the direction of creative accounting, in which inconvenient budget realities are simply hidden rather than confronted and dealt with honestly.

Q. Republicans argue that privatization does not create new debt but rather exchanges implicit debt for explicit debt. Former White House official Glenn Hubbard likened it to "prepaying part of a mortgage." Is this true?

The purported rationale for excluding Social Security privatization from the budget's deficit and debt totals is that the debt associated with Social Security privatization is not really new debt, it is just bringing forward future liabilities. This argument is flawed for several reasons.

Diverting Payroll Taxes into Private Accounts Pays for Nothing. Diverting payroll taxes into private accounts – and thereby driving up deficits and debt to pay for current Social Security benefits – by itself does absolutely nothing to improve Social Security's long-range balance, and in fact makes it worse. Congress would still have to make other changes to revenues and Social Security's defined benefits to bring the system back into balance, and these changes would have to be larger than they otherwise would be because of the additional shortfall created by the payroll tax diversion. "Paying for" private accounts with deficit spending makes about as much sense as it would for a family to take out a consumer loan in order to pay their mortgage. The family would not improve its overall net financial position through such a course of action.

Timing Matters. In the aggregate, the current-law scenario of near-term projected Social Security surpluses followed by growing deficits in future decades may look equivalent to a privatization plan that increases the debt today but reduces costs decades from now. However, budget savings in the distant future will not help our economy today. And a massive increase in publicly held debt and associated interest costs in the near term could leave the U.S. government in a weaker position to deal with other future challenges.

A Projected Future Imbalance Is Not the Same As Debt. Debt is a binding obligation of the U.S. government. The predicted future gap between Social Security resources and expenses represents potential debt, which can be reduced through policy changes ahead of time, thereby preventing the need to finance that debt by selling bonds. Congress has a long record of making reasoned adjustments to Social Security over the years to keep the system in financial balance and responsive to social needs. The current situation is no different. There is no reason to believe that a gap between Social Security resources and expenses projected to occur in the future will automatically translate into new debt.

The White House Contradicts Itself on the Nature of Future Liabilities. Administration officials take inconsistent positions on the nature of the Social Security shortfall projected under current law. For example, the OMB director said that privatization would not add to the debt because it would mean "merely bringing forward obligations that the United States already has."[8] But that same week, he also said that "if left unattended, the system will be unable to make good on its promises."[9] Another White House spokesman was quoted as saying that if nothing is done, benefits could eventually plummet by up to 33 percent.[10] When White House officials are trying to minimize the debt implications of their plan to privatize Social Security, they argue that the projected Social Security shortfall means that there is already a huge implicit debt. But they also argue that future retirees will experience a drastic benefit cut if nothing is done to change the system, which implies that the system is self-balancing and therefore has no implicit debt. These two positions are inherently in conflict with each other.

Q. Republicans argue that Social Security reform should be measured over a longer time frame, say, 30 years or more. Does it make sense to adopt a longer budget window for Social Security?

Social Security analysis does require a long-term perspective, but that does not justify adopting fiscally irresponsible policies now. On paper, most Social Security privatization plans would increase publicly held debt relative to current law for the next 50 or 60 years, after which the debt would shrink. There are several problems with pointing to savings several decades away to justify substantially higher deficits today.

Republicans Assume They Know What Future Generations Will Want. A lot can change over 60 years, in terms of technology, demography, the economy, geopolitics, and domestic political priorities. Plans that call for taking on a massive amount of debt now in exchange for the promise of lower debt 60 years from now presume that today's policy makers can correctly anticipate the needs and priorities of generations far in the future. In reality, driving up the debt today will merely serve to reduce the policy options available to future decision-makers, because they will be saddled with large interest burdens that must be paid before any other policy changes can be considered.

Republicans Lack Credibility on Long-Range Forecasts. Republicans have repeatedly changed their story on the appropriate time frame for budget forecasting. In 2001, the President supported ten-year forecasts, because the projected surplus at the time made it appear that the nation could pay down a record amount of debt and still have enough left over for a significant tax cut. After those projections proved overly optimistic and the budget sank into deficit, the Administration continued to push long-term tax cuts but changed to a five-year budget, arguing that ten-year estimates are too unreliable. The Republican-controlled Congress followed suit, with the House and Senate each producing versions of the 2005 budget resolution that looked out only five years. Ultimately, the two chambers were unable to agree on a budget resolution — even after stripping it down to just one year. Meanwhile, the $5.6 trillion surplus originally forecast for 2002-2011 has deteriorated to a deficit of more than $2.6 trillion — a negative swing of nearly $8.2 trillion.

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[8] "Bush Pushes Social Security Agenda, Vows Not to Increase Payroll Taxes," *Bureau of National Affairs,* December 10, 2004.

[9] "Most G.O.P. Plans to Remake Social Security Involve Deep Cuts to Tomorrow's Retirees," *The New York Times,* December 14, 2004.

[10] "Social Security Benefit Cuts Eyed," *Boston Globe,* Dec. 12, 2004.

Q. How will putting the costs of Social Security privatization "off budget" affect the actual federal deficit and debt?

The President and Republicans may leave the costs of Social Security privatization out of the budget entirely, or they may include the costs but display them separately from the deficit and debt. Either way, the Republican plan relies on presentation and perception. No matter what name they give to the debt, and no matter how they display it (or fail to display it) in the budget, somebody still has to buy it. No gimmick will be able to conceal the inevitable explosion in federal borrowing. The publicly held debt is what it is. The Treasury would have to sell tens of trillions of dollars' worth of additional government bonds over the next 50 to 60 years to float the costs of privatization. It remains to be seen how the financial markets will respond to that flood of new Treasury debt.

Q. What are the implications for the rest of the budget if we "pay for" privatization?

One of the privatization plans (sponsored by Rep. Ryan and Sen. Sununu) would finance part of the cost of diverting payroll taxes by reducing future spending in the rest of government. If defense, homeland security, and popular entitlements such as Medicare and veterans benefits are excluded from these cuts, by 2013 domestic discretionary programs would receive only half of the funding necessary to maintain services at today's levels. Significant reductions in activities such as law enforcement, education, biomedical research, child care, national parks, environmental protection, transportation, and dozens of other activities would directly affect opportunities and everyday quality of life for average Americans. It should be noted that the President already counts on savings from cutting domestic discretionary services to help reduce the projected deficits created in large part by his unaffordable tax-cut policies. The Administration and Congress cannot reduce the already-exploding deficit and debt, *and* offset the costs of Social Security privatization, by gutting the same programs twice.

Q. How do CBO and the Administration estimate the returns from investing in private assets? Is there a "free lunch" from investing in equities?

Most privatization plans achieve long-range budget improvements on paper by assuming higher returns from private assets – the so-called "equity premium." However, higher returns bring higher risks. Many financial economists recommend assuming a risk-adjusted rate-of-return— equal to the Treasury bond rate — to account for the greater uncertainty associated with this risk.

CBO assumes a risk-adjusted rate of return. In 2001, Congress passed the Railroad Retirement and Survivors' Improvement Act, which directed the government to invest Railroad Retirement trust fund assets in private securities. In scoring that bill, CBO determined that after adjusting for the additional risk associated with private securities, the expected returns on private securities are the same as those on government securities. Since then, CBO has developed long-range estimating capabilities and has produced analyses of the budget effects of several Social

Security privatization plans. CBO continues to assume a risk-adjusted rate of return.[11]

The Social Security Administration (SSA), which has traditionally scored the long-range financial effects of Social Security plans, assumes a higher yield from private assets, with no risk adjustment. To show the range of possible outcomes of a plan, SSA also develops projections for scenarios in which equities earn no more than the Treasury rate.

Accounting for risk produces vastly different estimates of benefit levels. For example, under the most commonly cited plan developed by President Bush's Social Security commission, SSA estimates that a 2075 retiree with average earnings would receive a combined total benefit (Social Security traditional benefit plus private account proceeds) of $1,615 (2001 dollars), or 80 percent of benefits scheduled under current law, without accounting for market risk. But after accounting for this risk, his total projected benefit drops to $1,227, or 60 percent of benefits scheduled under current law.

Some privatization plans appear to put the burden of risk on the government rather than individuals. They purport to provide current-law benefits in case accounts underperform. SSA estimates that one such plan (by Rep. Shaw) would achieve long-range balance — without accounting for market risk. However, after accounting for risk, SSA finds that under this plan, the Trust Fund would become exhausted in 2049, only seven years later than the date of exhaustion projected under current law.

[11]CBO uses risk-adjusted rates of return for point estimates. When estimating a range of potential outcomes, CBO assumes a higher rate of return for private assets, since the uncertainty is reflected in the range of outcomes.

III. THE ECONOMIC IMPLICATIONS OF SOCIAL SECURITY PRIVATIZATION

Q. Republicans say the financial markets already factor in Social Security's long-term "implicit debt" under current law, so the debt effects of privatization would have no effect on bond prices. Is there any evidence to support this argument?

There is no evidence that the markets are that far-sighted. If they are, it could just as easily be true that the markets, examining past history, assume that Congress will make adjustments as necessary to keep Social Security in balance. That is, after all, what Congress has done in the past. Adding trillions of dollars to the already growing debt may serve to unsettle the markets and cause them to lose confidence in the government's financial stewardship — especially if that debt is not transparently recorded in the government's budget and financial statements.

Q. Will Social Security privatization increase national savings, thereby boosting economic growth and making it easier to support retirees in the future?

Most privatization plans "pay for" the accounts by running larger federal deficits for the next four or five decades. Such a scheme would, at best, have no effect on national savings, which is the sum of private and public saving. In fact, a debt-financed Social Security privatization scheme can be expected to lead to a net *reduction* in national savings. This would occur because many households likely would respond to the creation of personal accounts in Social Security by reducing their other forms of saving.

Borrowing money to save money on the federal level makes about as much sense as it would for a family to take out a consumer loan in order to make contributions to a savings account. The family would not improve its overall net financial position through such a course of action. Similarly, diverting payroll taxes to private accounts will not increase national savings if the account deposits are offset by a parallel increase in federal borrowing. Taking on debt to fund private Social Security accounts is not an "investment" in the same sense as, say, taking on debt to build schools, roads, and other assets that improve economic output over many years. That is because borrowing money to save money amounts to nothing more than shuffling the nation's financial resources, without adding anything to the capital stock. Only a net increase in national savings will stimulate investment and economic growth, and thereby increase the total amount of economic resources available. Without an increase in total economic resources, the higher returns earned by investing some Social Security payroll taxes in private assets would have to be offset by lower returns elsewhere in the economy.

Q. Opponents of privatization note that most of the proposals circulated so far would drastically increase the publicly held debt. Why should a family trying to earn a living, raise children, and save for the future care about this?

A privatization plan that relies on massive borrowing threatens to undermine future standards of living for all Americans, because it would likely lead to a net reduction in national saving. Such an outcome would leave families worse off, because a decline in national savings translates into lower economic growth — and a therefore a lower future standard of living — than would otherwise be the case. This in turn would reduce the capability of our children and grandchildren to pay back what the federal government has borrowed — whether that payback take the form of higher future taxes or reduced government services.

The large increase in the supply of federal debt being sold in financial markets would also put upward pressure on interest rates, which would make it more expensive for families to take out loans for things like homes, cars, and college education. The growing interest burden would undermine the government's ability to meet other important needs, such as improving education, providing college financial aid, protecting the environment, making quality child care affordable, and investing in transportation and other infrastructure to promote economic growth. Some of the privatization plans would drive up federal interest payments by as much as $100 billion a year within the first decade. That is more than the government spends today on education or transportation. It is more than the government spends on science, space, energy, environmental protection, agriculture and national parks combined.

Q. Can the government afford to take on an estimated $1 trillion to $5 trillion in new debt over the next ten years to finance privatization?

The government will have its hands full trying to manage the mountain of debt that already is accumulating under the President's failed policies. After four years marked by trillion-dollar tax cuts that largely benefit the well-off, ongoing major military operations in Iraq and Afghanistan, creation of a Medicare prescription drug benefit, and other budget demands in areas such as homeland security, the debt held by the public has increased from $3.4 trillion in 2000 to $4.3 trillion today. By 2015, the debt held by the public is projected to rise to $5.7 trillion under current law — and that does not even include the cost of ongoing operations in Iraq, extending the expiring tax cuts, or fixing the Alternative Minimum Tax, let alone privatizing Social Security. Accounting for these costs would add *another* $5.4 trillion to the debt over the next ten years. So far, the President and Congressional Republicans have offered no viable plan for getting federal budget deficits and the debt under control. Privatizing Social Security will make the debt situation even more unmanageable.

More than 90 percent of the additional debt accumulated during the Bush Administration has been financed by foreigners. This heavy reliance on international capital makes our economy more vulnerable to forces beyond our control. If foreign lenders suddenly decide that U.S. fiscal policy is too irresponsible, they may dump dollars, cause a spike in inflation and interest rates, and possibly precipitate an international financial crisis. Adding trillions more to our debt to finance Social Security privatization will only increase U.S. economic vulnerability.